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No. 96-1107

In the Supreme Court of the United States

OCTOBER TERM, 1996

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

TEXACO, INC. AND SUBSIDIARIES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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TABLE OF AUTHORITIES

Cases:	Page
Argentina v. *Weltover*, 504 U.S. 607 (1997)	4, 6
Commissioner v. *Culbertson*, 337 U.S. 733 (1949)	3, 6
Commissioner v. *First Security Bank*, 405 U.S. 394 (1972)	1, 2, 5, 6
L.E. Shunk Latex Products, Inc. v. *Commissioner*, 18 T.C. 940 (1952)	4, 5
United States v. *Basye*, 410 U.S. 441 (1973)	1, 2, 5, 6
Statute and regulation:	
Internal Revenue Code, 26 U.S.C. 482	5, 6, 7
26 C.F.R. 1.482-1(b) (1981)	6
Miscellaneous:	
B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* (1987 ed.)	5-6

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Respondent errs in asserting that its purchases of Saudi crude oil did not stem from "a consensual agreement" but were instead dictated by foreign law (Br. in Opp. 15). Building upon that flawed foundation, respondent mistakenly asserts that this Court's decision in *Commissioner* v. *First Security Bank*, 405 U.S. 394 (1972), rather than its decision in *United States* v. *Basye*, 410 U.S. 441 (1973), governs this case. Review by this Court is warranted because of the fundamental misapplication by the courts below of the decisions of this Court and the extraordinary importance of the question presented.

1. The mere fact that Texaco was unusually dependent upon supplies of Saudi crude oil in 1979 and 1980 (see Pet. 7-8 & n. 7) does not exempt Texaco from the

operation of the internal revenue laws of the United States. As the Chairman of Exxon has straightforwardly acknowledged, the Saudi resale condition was nothing more than a "condition[] of sale" (Tr. 154-155). Texaco, Exxon and the other Aramco participants "always had the choice of not buying Mr. Yamani's oil" (*ibid.*). The fact that Texaco had a great need for supplies in 1979 and 1980 does not mean that Texaco had a legal obligation to purchase Saudi oil or to purchase such oil under any specific set of contractual terms. For the reasons described in the petition (Pet. 16-19), the fact that the seller had sufficient market power to dictate the terms of sale does not make those terms a "law."[1]

Respondent does not dispute that, in determining whether the reasoning of *First Security* or *Basye* controls, the critical focus should be on whether the conduct of the taxpayer was restrained by law or was instead consensual. See Br. in Opp. 17 ("[b]oth courts below agreed with this proposition"). Respondent and the courts below err, however, in assuming that a consensual agreement cannnot exist within the meaning of *Basye* unless the taxpayer could have successfully negotiated a different result. The Tax Court, for example, did not conclude that Texaco's purchases

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[1] If, for example, any private supplier had imposed a resale price condition on sales to Texaco, the fact that Texaco "really needed" those supplies would not exempt Texaco from the consequences that attach to such "a consensual agreement" under the laws of the United States—whether those consequences stem from antitrust laws or internal revenue laws. Respondent and the courts below erred precisely in concluding that the mere fact that the seller in this case was the Saudi government somehow converts a consensual commercial arrangement into a "law" that removed all freedom of action from Texaco.

of crude oil were not the product of "a consensual agreement"; it concluded only that Texaco had insufficient market power to avoid the "non-negotiable" resale price demand of the seller (Pet. App. 149a; see Br. in Opp. 18). The fact that the seller's demand was "non-negotiable," however, does not mean that Texaco *had* to agree to it. It means only that Texaco *did* agree to it in order to purchase the crude oil.

By agreeing to this term of sale, Texaco voluntarily surrendered its power to allocate the associated income among its subsidiaries. Texaco's *voluntary* decision to accept the terms demanded by the seller does not prevent the Commissioner from applying "the first principle of income taxation: that income must be taxed to him who earns it." *Commissioner* v. *Culbertson*, 337 U.S. 733, 739-740 (1949). As this Court held in *Basye*—in language that applies directly to this case—"[t]he entity earning the income * * * cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person or entity." 410 U.S. at 449.[2]

2. The question of recurring importance that is presented in this case is whether a foreign government can enter the marketplace and, in dealings with private parties, establish terms of sale that displace the provisions of United States law that govern the taxation of United States corporations. In the pre-

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[2] Respondent does not dispute that, for the reasons described in the petition, the allocation of this income to respondent does not violate the terms of the Saudi restriction. See Pet. 14-15 & n.9. In being required to pay tax on the income it has earned, Texaco is merely being required to comply with United States law; it is not being required to violate any foreign law.

sent case, the foreign government was selling supplies of a commodity that was temporarily in short supply, and it was imposing restrictions *only* for the supplies that it sold.[3] The "restriction" thus imposed was purely contractual in character and in effect, for it did not purport to bind or in any other fashion regulate anyone other than those who consented to the restriction by purchasing the supply.[4]

The facts of *L.E. Shunk Latex Products, Inc.* v. *Commissioner*, 18 T.C. 940 (1952), on which respondent relies (Br. in Opp. 24), are therefore markedly different. In *Shunk Latex*, the United States government was not in the business of selling either raw rubber or condoms. The United States also did not seek to impose any contractual resale price restraints as a condition of sale of such materials. Instead, the government established price ceilings on those products and made it unlawful for any taxpayer to conduct business at prices in excess of those established ceilings. On these facts, the court held in

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[3] The cases cited by respondent (Br. in Opp. 22 n. 21) that involve situations in which a foreign government is acting as a "regulator of a market" (*Argentina* v. *Weltover, Inc.*, 504 U.S. 607, 614 (1992)) are thus inapposite. The Saudi terms of sale were not provisions of general application that "regulated" a market; they were contractual terms of sale that bound only its customers—those who purchased oil directly from the government. See Pet. 21-24.

[4] Moreover, when those parties converted the crude oil into refined products (or when their affiliates did so), the contractual resale "restriction" utterly disappeared. Pet. App. 4a. As the Saudi Oil Minister emphasized (Pet. App. 48a):

> [T]he oil companies are definitely making much higher profits in the downstream by refining Saudi crude and selling the products at higher prices. This we cannot control.

Shunk Latex that the Commissioner could not allocate profits to sellers based upon theoretical prices that exceeded the ceilings established by federal law. 18 T.C. at 961.[5]

The difference between a law that requires universal obedience and a contractual term that is binding only on those who have agreed to it is the core distinction between *First Security* and *Basye*. The decision in *First Security* precludes the allocation of income to a taxpayer who, under a generally applicable law, is precluded from conducting the commerce being taxed. 405 U.S. at 405. The decision in *Basye*, by contrast, *permits* the allocation of income to a taxpayer who, under a consensual commercial arrangement, has agreed to terms that cause a deflection of the income it has earned to an untaxed affiliate. 410 U.S. at 449.

3. The courts below misunderstood and misapplied this critical, controlling distinction between *First Security* and *Basye*. As the petition explains (Pet. 25-26 & n. 14), the decision of the court of appeals thereby creates favorable tax consequences for commercial restrictions imposed on commercial sales made to United States corporations by foreign Nations. The reasoning applied by the courts below would create an enduring opportunity for substantial abuse, for it obstructs the plain objective of Section 482 of the Internal Revenue Code to "prevent[] artificial shifting, milking, or distorting of the true taxable incomes of

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[5] In the course of holding that income could not be allocated to a corporation that could not lawfully participate in the business that generated the income, this Court cited *Shunk Latex* with approval in *Commissioner* v. *First Security Bank*, 405 U.S. at 406.

commonly controlled enterprises" (B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 15.03, at 15-14 (1987 ed.)). See Pet. 25-26 & n.14.

Respondent misses the point of the statute in contending that there is no opportunity for abuse if courts apply "heightened scrutiny" to ensure that a foreign sales restriction was adopted by the foreign government without the collusion of the United States taxpayer (Br. in Opp. 25, quoting Pet. App. 113a). The function of Section 482 is to determine the "true taxable income" of a United States taxpayer (26 C.F.R. 1.482-1(b) (1981)) and "to correct artificial intragroup pricing policies" that shift income "to affiliated foreign corporations that are not generally subject to U.S. tax." B. Bittker & J. Eustice, *supra*, at 15-16. The taxpayer's "motivation or purpose" in entering into the arrangement is not relevant (*id.* at 15-14). A reallocation is necessary clearly to reflect the taxpayer's income when, as here, the taxpayer's activities have earned the income that has been realized instead by foreign affiliates that the taxpayer controls—for income is to be taxed "to him who earns it" (*Commissioner* v. *Culbertson*, 337 U.S. at 739-740).

4. This case—along with the companion case involving amicus Exxon—involves more than five billion dollars of taxes and interest. The issue presented in this case arises at the interstices of this Court's decisions in *Basye* and *First Security*, and it implicates principles that the Court has applied in the governmental immunity context in decisions such as *Argentina* v. *Weltover, Inc.*, 504 U.S. 607 (1992). See Pet. 19-23. Its resolution thus requires an explanation of this Court's jurisprudence that only this

Court can authoritatively provide. Review by this Court is warranted by the extraordinary importance of this case for the public fisc, by the broad scope of its potential future applications, and by the evident need for guidance in the lower courts on the proper application of Section 482 to commercial transactions involving foreign governments.

For the reasons stated above and in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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